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ARE DEFECTIVELY INCORPORATED ASSOCIATIONS PARTNERSHIPS?

Upon this question, to quote from a learned author, "there is almost every variety and shade of judicial opinion." [1] "There is a class of cases," continues this writer, "holding to the simple, just, and easily applied doctrine that where a number of coadventurers assume or attempt, under the provisions of a general statute, to organize themselves into a corporation, and fail to take the steps which that statute makes essential to their becoming incorporate, and assume to contract corporate debts without having taken such steps, they are liable for such debts as partners."

That this doctrine is simple and easy of application does not admit of doubt. It has the further merit of being in accord with the rule, everywhere recognized, that, at common law, "there is no intermediate form of organization between a corporation and a partnership." [2] If persons organize a joint-stock company, for the purpose of carrying on a business, and do carry it on with a view of profit, the common law treats them as a partnership, [3] although they did not intend to form a partnership, and believed that they

[1] Thompson's Commentaries on the Law of Corporations § 2992.

[2] Ricker *v.* American Loan and Trust Co. (1885) 140 Mass. 346, 348. At p. 349, it is said: "Since this association is not a corporation, its members must be partners; unless, indeed, they are simply co-owners. But we cannot look upon them as simply co-owners."

[3] Grady *v.* Robinson (1856) 28 Ala. 289; Sebastian *v.* Booneville Academy Co. (Ky. 1900) 56 S. W. 810.

had not formed one.[1] The advice and skill of "the ablest legal assistants" such stockholders could obtain,[2] never saved them from the unlimited personal responsibility of partners. Their long sought privilege of limited liability was gained only by legislation.[3]

It has the further merit of being in accord with the rule which is applied to limited partnerships. The special partner in such an association is liable for its debts, and is in law a general partner; and the association is a general partnership, unless the statutory requirements for the formation of a limited partnership have been complied with.[4]

Is the Doctrine Just?

Undoubtedly the enforcement of this doctrine results at times in hardship to individuals. It is the same hardship, however, as that which is inflicted upon the member of a common law joint-stock company, or upon the special partner in a limited partnership, who supposes that his contract and conduct do not make him a general partner, when by the well established rules of law they do bring him into that relationship. In Farnum *v.* Patch,[5] and Carter *v.* McClure,[6] the defendants took part in organizing co-operative stores. They did not suppose they were forming a copartnership with their associates in the undertaking. Their prime motive was to obtain goods through the store, at a small advance upon the wholesale price, and thus escape what they deemed to be the extortion theretofore practiced upon them by local merchants. In each case, the business was carried on at a loss, and the defendants were compelled to pay to creditors several thousand dollars over and above their shares of stock. "Their belief or understanding," said the courts in deciding those cases, "that during the

[1] Farnum *v.* Patch (1880) 60 N. H. 294; Wells *v.* Gates (N. Y. 1854) 18 Barb. 554; Imperial Shale Brick Co. *v.* Jewett (1901) 169 N. Y. 143, 150; Carter *v.* McClure (1897) 98 Tenn. 109; 38 S. W. 585.

[2] In re Agriculturist Cattle Ins. Co., Baird's Case (1870) 5 Ch. App. 725.

[3] Rex *v.* Dodd (1808) 9 East 516, 527; Greenwood's Case (1854) 3 De G. M. & G. 458, 477; Lindley on Companies (6th Ed.) 354 et seq.

[4] Pierce *v.* Bryant (Mass. 1862) 5 Allen 91; Myers *v.* Edison General Electric Co. (1896) 59 N. J. L. 153; 35 At. 1069.

[5] (1880) 60 N. H. 294, 327. [6] (1897) 98 Tenn. 109, 114, 116.

time they were stockholders, they were not 'partners,' in the legal sense of the word, was a mistaken and immaterial view of the law."

Does the stockholder in an association which he has attempted but failed to incorporate, who is held liable as a partner for association debts, make out any greater case of hardship, than the stockholders in the co-operative stores? He did not suppose that his connection with the business would subject him to partnership liabilities, it is true. He thought that he was escaping such liabilities by calling into existence that artificial person, a corporation. The law pointed out clearly the way in which such corporation could be organized. He failed to follow that way. The business was carried on with the money which he and his associates had contributed; it was carried on for their profit; and by the men whom they had chosen, and in the manner which they directed. Should not their belief that they had called into existence an artificial person, a corporation, and had thus limited their liability for its debts to their contributions to its capital, be deemed simply "a mistaken and immaterial view of the law"? If there is any hardship in holding them personally liable for all the debts of the business, does it not come from these two principles—first, that everyone is bound to know the law; and second, that each partner is liable for all of the debts of the partnership?

The Supreme Court of Louisiana had occasion recently to deal with this topic, and expressed itself in these words:[1] "If there has been any hesitation on our part in reaching a conclusion, it was after giving consideration to thoughts quite suggestive and prettily expressed by counsel, in referring to the spirit of equity of modern jurisprudence, which they invoke as having sought to have justice, pure and simple, administered between man and man; which has sought to rise above matter of form, to keep abreast the advance of other sciences, and to make the law loved rather than feared. It was forcibly said at the bar that the law has bidden adieu to the era of snares and traps into which the innocent and unwary could be led to their own undoing. Everywhere equity is predominant. These are ap-

[1] Lehman *v.* Knapp (1896) 48 La. Ann. 1148, 1155; 20 So. 674.

pealing thoughts. But if the law has determined a matter with all its circumstances, equity cannot intermeddle." Accordingly the court proceeded to decide the case in accordance with what Mr. Thompson well described as "the simple, just and easily applied doctrine."

SOME OF THE OBJECTIONS TO THIS DOCTRINE.

A learned judge[1] has stated the following objections to the maintenance of a suit for the enforcement of this doctrine: "It involves judicial nullification of franchises and powers enjoyed and exercised by a *de facto* corporation as a distinct entity recognized by the law, acquiesced in by the State; defeats the corporate character of the contract; changes the relation from that of stockholders to that of partners, substitutes other and new parties to the contract; effects the imposition of an enlarged liability, which they did not assume, but intended to avoid, so understood by the creditor when he contracted the debt with the corporation as such. The contract is valid and binding on the corporation, which the creditor trusted. No injustice is done him, for all his rights and remedies are preserved by the principle that the corporation and the shareholder are estopped from denying its legal existence, as against him. It will not answer to say that he is not repudiating but enforcing the contract. He repudiates the party, the corporation, with which he made the contract and seeks its enforcement against parties who never entered into contractual relation with him."

(1) *Nullification of Franchises.* That a judgment, obtained by a creditor against the stockholders or managers of a *de facto* corporation as partners, has any effect upon the legal status of the so-called corporation is a surprising proposition. Would such a judgment be a bar to a subsequent action by the State to forfeit the charter? Could it be offered in evidence by any other creditor in an independent suit brought against the stockholders or managers? Would it be receivable in evidence against any other creditor suing the corporation, under a defense that the cor-

[1]Clopton, J., Snider's Sons & Co. *v.* Troy (1890) 91 Ala. 224; 8 So. 658; 43 Al. Law J. 295; 9 R. & C. L. J. 272; 11 L. R. A. 515; 24 Am. St. R. 887.

poration never had a legal existence? In Lehman *v.* Knapp[1] the court said: "The defendants urge that the State alone can question corporate existence. That may be in cases in which it is sought to have the charter forfeited; but here the suit is to enforce the personal liability of officers of a corporation for corporate debts which they have incurred, because of their violation of the general statute. It may be maintained by creditors without direct proceeding taken at the instance and in the name of the State. The State has no interest in the indebtedness, and no reason arises, in consequence, requiring her intervention in the matter."

This, it is submitted, is good sense and good law. The creditor does not ask to take away any franchises or powers from the pretended corporation. A judgment in his favor against the stockholders or managers as partners does not annul the corporation charter, or have any legal bearing upon it. If the facts elicited in such a litigation are brought to the attention of the State officials, they may or they may not institute proceedings to forfeit the franchise. The doctrine that the validity of a corporation cannot be attacked collaterally "is derived from tradition. When the franchise was a direct grant made by the executive or legislative department, the charter was deemed the act of a co-ordinate branch of the government; and, in deference to the political power, was treated as a judgment which could not be impeached collaterally." At present, however, the incorporation has become the act of the individuals, organizing the association. Compliance with the statutory requirements is the only condition of obtaining the franchise, with the consequent limitation upon the corporator's liability for the association debt. There is no longer any reason for the rule, that the validity of a corporation shall not be attacked collaterally, in a suit, the very object of which is to subject the defendants to an established common law liability, from which they have sought to screen themselves by incorporation.[2]

Indeed, in most of the jurisdictions which prohibit col-

[1] 48 La. Ann. (1896) 1148, 1153-4.

[2] Principles of Partnership. By James Parsons (2d Ed.) § 24.

lateral attacks upon the validity of *de facto* corporations, such attacks are allowed if the defects in the incorporation proceedings are very great ;[1] or if the statute under which the incorporation is attempted is unconstitutional ;[2] or if the association carries on a business which the corporation statute does not authorize;[3] or if the existence of the alleged corporation is denied.[4]

(2) *Changing the Contract.* This objection is specious rather than sound. A business is conducted in the name of John Smith. X becomes a creditor for goods sold. He takes a promissory note for the debt signed "John Smith." When selling the goods and taking the note, he supposes that John Smith is the sole owner of the business, and gives credit in accordance with that supposition. Afterwards, he discovers that John Jones was all this time a dormant partner of John Smith. X is entitled to sue Smith alone, or to sue Smith and Jones. If he brings an action against Smith, the latter is estopped from pleading the non-joinder of Jones. If X sues both, neither can be heard to say that he is changing the contract and substituting another and new party to the contract, thereby securing the pecuniary responsibility of one, whose liability for the debt he did not stipulate for, and did not know that he was obtaining.[5] A similar result ensues, in actions against those who have undertaken to organize a limited partnership, as we have already seen.

It is submitted that the creditor of a business association, who sues the stockholders as partners upon discovering that they were not a corporation, acts precisely as the law permits the creditor of a dormant partner to act. If the

[1] Bergeron *v.* Hobbs (1897) 96 Wis. 641, 644; 71 N. W. 1056.

[2] Brandenstein *v.* Hope (1894) 101 Cal. 131; 35 Pac. 562; Eaton *v.* Walker (1889) 76 Mich. 579; 43 N. W. 638; Snyder *v.* Studebaker (1862) 19 Ind. 462.

[3] Henry *v.* Simanton (1903) 64 N. J. Eq. 572; 54 At. 153; Empire Mills *v.* Alston Grocery Co. (1891) 4 Willson Tex. App. 346; 15 S. W. 505; 12 L. R. A. 366.

[4] Elgin Nat. Watch Co. *v.* Loveland (1904) 132 Fed. 41, 45, and cases there cited.

[5] Winship *v.* Bank of the U. S. (1831) 5 Pet. 529, 561; Mohawk Nat. Bank *v.* Van Slyck (N. Y. 1883) 29 Hun 188; Chamberlain *v.* Madden (S. C. 1854) 7 Rich. L. 395; Reab *v.* Pool (1889) 30 S. C. 140; 8 S. E. 703; Swan *v.* Steele (1806) 7 East 210; Robinson *v.* Wilkinson (1817) 3 Price 538; Beckham *v.* Drake (1841) 9 M. & W. 79; (1843) 11 M. & W. 315.

stockholders had desired to shield themselves by a contract, when they had not shielded themselves by validly incorporating, they should have secured from the creditor a clear and express stipulation that he would look only to the pretended corporation, or to its assets, for satisfaction of his claim. Exemption from their common law liability is not to be inferred from equivocal language or conduct. It must be established by clear and express stipulation. Chancellor Kent states the rule as follows: "The members of a private association may limit their personal responsibility, if there be an explicit stipulation to that effect made with the party with whom they contract, and clearly understood by him at the time. But stipulations of that kind are looked upon unfavorably, as being contrary to the general policy of the law."[1]

Lord Lindley's view is substantially the same. He says: "Various attempts have been made from time to time to form partnerships without exposing their members to ruin in the event of loss. But the only effectual method of accomplishing this object is to stipulate with each creditor that he shall be paid out of the funds of the partnership, and that he shall not be entitled to require the individual partners to pay more than a certain amount of those funds."[2]

In Hess and others *v.* Werts[3] it appeared that Hess and his associates had organized and conducted to a failure "The Farmers and Mechanics Bank of Fayette County, Penn." They issued notes "payable to bearer on demand out of their joint funds, according to the articles of association." By those articles it was provided that payment was to be made when convenient. In a suit on these notes Hess and his associates sought to escape personal liability on the ground that the stipulation quoted above exempted them from such liability. They were unsuccessful. Said Gibson, J.: "I see no reason to doubt, but that they may limit their responsibility, by an explicit stipulation, made with the party with whom they contract, and clearly understood by him at the time. But this is a stipulation so unreasonable on the part of the partnership, and affording such facility to the commission of fraud, that unless it

[1] Commentaries, vol. 3, p. 27. [2] Lindley on Partnership (5th Ed.) 27.
[3] (Pa. 1818) 4 Serg. & R. 356, 361.

appear unequivocally plain, from the terms of the contract, I will never suppose it to have been in the view of the parties. Unless the contrary clearly appeared, I would not suppose anyone so imprudent, as to contract solely on the credit of a fund, exclusively within the control of another, and of the solvency of which he could not command the means of obtaining a knowledge."[1]

It is precisely this imprudence, which Mr. Justice Clopton, and those who agree with him, impute to every creditor of a pretended corporation; and they base this imputation not on any such printed stipulation as appeared in Hess *v.* Werts, but upon the mere fact that a contract has been made with a business association, in a corporate name and upon an untrue representation by these associates that they were incorporated.

It is true, that in some jurisdictions which adopt Justice Clopton's view, the associates are held liable as partners to creditors who are not shown to have had any knowledge of the existence of a pretended charter, nor to have assumed that the associates were incorporated.[2] In such cases, say these courts, the creditors are not estopped to claim against the associates as partners.

(3) *Estoppel upon Creditors.* If, say these same courts, one deals with these associates "as a corporation, he is estopped from claiming against them in any other capacity, even though they failed to record their charter," or to do some similar act, which the statute makes a condition precedent to the existence of a corporate franchise. Why should they be so estopped?

The answer most frequently given is, that, as the *de facto* corporation would be estopped to deny its corporate existence, if the creditor sued it, the creditor should also be estopped to deny that existence. This conclusion, it is submitted, is not justified. We have seen that the osten-

[1] In Imperial Shale Brick Co. *v.* Jewett (1901) 169 N. Y. 143, 150; 62 N. E. 167, 169 it is said: "This company or association was not incorporated, was in nowise exempted by law from partnership liability, except as it should in its agreement with the insured actually and explicitly so exempt itself."

[2] Guckert *v.* Hacke (1893) 159 Pa. 303; 28 At. 249; New York Nat. Ex. Bank *v.* Crowell (1896) 177 Pa. 313; 35 At. 613; Slocum *v.* Head (1900) 105 Wis. 431; 81 N. W. 673; 50 L. R. A. 324.

sible partners are estopped from denying that they are the only members of the firm, when sued by one who has become a creditor while the existence of a dormant partner was concealed by them; but that the creditor is not estopped from such denial; that he may join the dormant and ostensible partners as defendants, although he supposed he was contracting with the ostensible partners only, and did not know that he was getting the personal credit of the dormant partner. Of course, the individuals who are carrying on business as a corporation, should be estopped from denying the corporation's existence, as against one who has been induced to deal with the association, by the representation of these individuals that it had a valid existence. But when such person discovers that the representation was untrue, why should he not be at liberty to sue the individuals as partners? What act has he done, what statement or representation has he made, which has induced these individuals to so act, that a suit against them as partners would operate as a fraud upon them? It is submitted that the situation of such a person is most unlike[1] that of one, who has received property or pecuniary benefit from a pretended corporation and, in consideration thereof, has deeded property to it[2] or given it his note or other obligation.[3] In such circumstances, it would be most unconscientious in him, and a fraud upon others, to recover the land, or to escape the payment of an honest debt by denying the existence of the corporation.

(4) *Intention not to form a Partnership.* In the latest edition of Parsons on Partnership,[4] it is said: "Where there is shown to be an association for business purposes it is presumed to be a partnership; if the associates wish to escape liability on the ground that the association is incorporated, they must prove that fact. But where persons unite to form a corporation, and believe that they have done so, it is clear that they should not be held liable as

[1] This is brought out clearly in Kaiser *v.* Lawrence Savings Bank (1881) 56 Ia. 104, 109.

[2] Snyder *v.* Studebaker (1862) 19 Ind. 462.

[3] Trustees of Vernon Society *v.* Hills (N. Y. 1826) 6 Cow. 23; Brower *v.* Appleby (N. Y. 1847) 1 Sandf. 158: Union Church *v.* Pickett (1859) 19 N. Y. 482.

[4] (1893) §§ 56, 57, p. 50.

partners; for they never intended to form an association which the law calls a partnership. In accordance with this principle it is generally held that where parties believe themselves to be stockholders in a legal corporation, they cannot be held liable to third persons as partners, though there is no corporate liability." Many cases from different jurisdictions are cited in support of the proposition, contained in the last sentence of the foregoing extract; but the only ones which squarely sustain it are those from Massachusetts. In nearly every other jurisdiction, the exemption from partnership liability is limited to the stockholders in a *de facto* corporation; and the essentials of such an organization are stated as follows: (1) A law (and this means of course a constitutional statute) under which the organization might have been incorporated; (2) A *bona fide* attempt to become incorporated; and (3) An assumption and exercise of such powers, as the pretended corporation was authorized by the law to exercise, unchallenged by the State.[1]

In Humphreys *v.* Mooney,[2] one of the cases cited, the court said: "The facts in a given case may sometimes warrant a holding of partnership liability, as when an already constituted partnership seeks to become incorporated, and exercises corporate powers without color of right, or where an associated company by deceit or misrepresentation, fraudulently attempts to evade individual liability through a false assumption of pretended corporate authority."

In Stafford Bank *v.* Palmer,[3] another cited case, the court said: "That a joint-stock corporation may be so defectively or illegally organized and conducted as to become an ordinary partnership and its members held liable under certain circumstances is undoubtedly true."

In Henry *v.* Simanton,[4] an incorporated grange carried

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[1] Bergeron *v.* Hobbs (1897) 96 Wis. 641; 71 N. W. 1056, and cases cited in prevailing and dissenting opinions.

[2] (1880) 5 Colo. 282, 288. [3] (1880) 47 Conn. 443, 448.

[4] (1903) 64 N. J. Eq. 572, 578; 54 At. 153, 156. The following statement is approved by the court: "Where the business for which incorporation is sought is not within the class of business mentioned in the act itself, the attempted incorporation is void, and the participants are liable as copartners." 1 Cook on Stockholders, p. 316, § 236. *Accord.* Ridenour *v.* Mayo (1883) 40 Oh. St. 9.

on a mercantile business, and its members were sued as co-partners by business creditors. Said Reed, V. C.: "In my judgment the business conducted by the members of the organization was so entirely aside from the power conferred upon the grange by the statute under which the incorporation was effected, that the business must be regarded as partnership, and not corporate."

In Bergeron *v.* Hobbs,[1] the prevailing opinion declared: "It is immaterial that the defendants have carried on a business under the supposed authority to act as a body corporate, in entire good faith. If they had not color of legal right, they have obtained no immunity from individual liability for the debts of the supposed corporation. Until the articles of incorporation are filed in the office of the register of deeds of the county, there is no color of legal right to act as a corporation. The filing of such a paper is a condition precedent to the right to so act. The defendants are not a corporation *de jure*, or *de facto;* but are liable for the plaintiff's claim as partners." Marshall, J., dissented, on the ground that the evidence established the existence of a corporation *de facto*, but added: "The existence of the law, and some attempt to comply with it, are essential, because without them there can be no assumption of the right to corporate existence in good faith. Persons cannot be said to honestly obtain the right to corporate existence in the absence of any law authorizing the organization, or in the absence of some honest attempt to comply with such law."

The foregoing quotations present fairly the views held by nearly every court, save that of Massachusetts, on the point in question. It is apparent from them, that the associates in a business organization do not escape liability as partners for its debts, unless they have organized a *de facto* corporation, which can be held liable for those debts.

Indeed, even in Massachusetts, it has been decided[2] that one who "believed himself to be a stockholder in a legal corporation" could be held liable personally to creditors for goods sold by them to the pretended corporation, and for the price of which they had taken a note signed by

[1] (1897) 96 Wis. 641; 71 N. W. 1056.

[2] Montgomery *v.* Forbes (1889) 148 Mass. 249.

the corporation. The jury found that the defendant did not in good faith attempt to organize the corporation, but that he believed it to be a valid corporation. "His belief," said the court, "in view of the facts of the case, is immaterial." In this case it is to be observed, the defendant had gone through the form of incorporating his business, in accordance with the statutes of New Hampshire. Articles, which in form complied with those statutes, were duly signed by himself and others and duly filed; and thereafter he carried on business as the Forbes Woolen Mills Corporation, under the statutory charter. His lack of good faith in the matter prevented even a *de facto* corporation from coming into existence, and left him personally liable for the business debts. Had the stockholders in this business been two persons instead of one, the reasoning of the court would seem to lead to the conclusion that they would have been liable as partners.

It is true, however, that the Supreme Court of Massachusetts in Fay *v.* Noble[1] did declare that, though the defendants had not succeeded in calling a corporation into existence, yet, as they in good faith believed they had incorporated themselves, they could not be held liable as partners, because they never intended to form a partnership. The decision, we submit, is irreconcilable with the doctrine which is uniformly applied in litigations growing out of joint-stock companies, co-operative store ventures and limited partnerships, and set forth earlier in this article. Its unsoundness consists in the assumption that there can be no partnership between persons without a specific intent to assume partnership liability. Undoubtedly, at the present time, both in England and in this country, the partnership relation cannot be instituted without the assent of the parties thereto. It is not forced upon them by an arbitrary rule of law. But, "it is possible for parties to intend no partnership and yet to form one. If they agree upon an arrangement which is a partnership in fact, it is of no importance that they call it something else, or that they even expressly declare that they are not partners. The law must declare what is the legal import of their agreements,

[1] (1851) 7 Cush. (61 Mass.) 188.

and names go for nothing, when the substance of the arrangement shows them to be inapplicable."[1]

In such a case as Fay *v.* Noble, persons contribute capital with which a common business is carried on in the name of the Western Boston Iron Company or some other pretended corporation. The associates undertake to incorporate, but "in consequence of an omission to comply with the requisites of law in the organization of a corporation, the proceedings are rendered void." The association is consequently "unorganized and incompetent to act as a corporation." Nevertheless, the common business is carried on with the capital thus contributed; by agents designated by the contributors; in accordance with the will of the contributors and for their profit. What is lacking, in such a case, to a partnership in fact? Only this, the intention to incur the liabilities of partners. Such lack, it is submitted, does not prevent the existence of a partnership.

Dealing with a somewhat similar case, arising under Bovill's Act in England, Jessel, M. R.,[2] said: "The intention exhibited on the face of the documents was to give the contributors all the benefits of the partnership, and, if possible, to secure them from suffering from the liabilities. The reason for it was this: the framers of the instrument thought that Bovill's Act could protect them. . . . It was said, and said with considerable force, by Mr. Chitty and Mr. Mathew, that they never intended to be partners. What they did not intend to do was to incur the liabilities of partners. If intending to be a partner is intending to take the profits, then they did intend to be partners. If intending to take the profits, and have the business carried on for their benefit was intending to be partners, then they did intend to be partners. If intending to see that the money was applied for that purpose and for no other was intending to be partners, then they did intend to be partners. But if it is tried by the other test, whether they intended to be protected under Bovill's Act from liability to third persons, then I think they did intend to be protected from liability." And the court held the contributors to be partners "and

[1] Beecher *v.* Bush (1881) 45 Rich. 188.

[2] Pooley *v.* Driver (1876) 5 Ch. D. 458.

liable to the consequences of being partners, and to the whole of the engagements of the partnership."

Nearly a century ago, a learned judge declared:[1] "An exemption from individual liability is the most substantial benefit derived from a charter; the having perpetual succession, ability to sue, and be sued corporately &c., are only matters of convenience and may be dispensed with." To secure this exemption is the prime object of persons who attempt to incorporate their business association. The intention to secure this exemption is not in truth, and ought never to be considered, the equivalent of an intention not to form the relation which the law regards as that of partnership. It is the failure to distinguish between these two intentions, and the consequent confusion of thought, that have led so many judges to hold that defectively incorporated associations are not partnerships.

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[1] Gibson, J., in Hess *v.* Werts (Pa. 1818) 4 S. & R. 356, 363.